Global Arc Panel Session

11.25am-12.20pm

Pension fund reform: creating a viable pension and social security system in an age of low returns and ageing population.

- (Chair) Craig Dandurand, Hedge Fund Portfolio Manager, CalPERS - USA
- Professor Laurence J. Kotlikoff, William Fairfield Warren Distinguished Professor and Professor of Economics, Boston University – USA
- Professor Keith Ambachtsheer Director, Rotman International Centre for Pension Management, University of Toronto – Canada
- Professor Shyam Sunder, James L. Frank Professor of Accounting, Economics, and Finance, Yale School of Management – USA
- Jerry Moriarty, Chief Executive Officer, Irish Association of Pension Funds – Ireland
- Linda T. Roseborough, Chief Investment Officer, State of New Mexico Treasurer’s Office – USA

- How do we define a government’s role in retirement planning?

Larry:

People are altruistic, particularly to the elderly. But they may be poor because they had bad luck or because they were shiftless and lazy when they were young. No one can say, which gives everyone an incentive when young to undersave and free ride on everyone else’s generosity when old. The only way to overcome this externality is to force everyone to save. So social insurance -- compulsory saving in this case -- is in everyone’s private self interest. Even libertarians get this right. The Cato Institute’s social security privatization reform proposal includes saving compulsion.

Keith:

OPTIMAL ROLES OF GOVT, EMPLOYERS, EMPLOYEES, FINANCIAL SERVICES INDUSTRY IN THE DESIGN AND MANAGEMENT OF RETIREMENT INCOME SYSTEMS ARE COUNTRY-SPECIFIC. FOR EXAMPLE, IN FINLAND THE FUNDAMENTAL DECISIONS ARE MADE THROUGH COLLECTIVE/CONSENSUS DECISIONS BY THE COUNTRY'S MAJOR EMPLOYER AND EMPLOYEE GROUPS. IT HAS LED TO A MANDATORY PARTIALLY PAY-GO (70%) PARTIALLY PREFUNDED (30%) SYSTEM MANAGED BY 6 NOT-FOR-PROFIT PENSION INSURANCE INSTITUTIONS. IT WORKS IN FINLAND, BUT COULD NEVER WORK IN THE USA. HAVING SAID
THAT, THE USA WOULD DO WELL TO DE-POLITICISE THE DESIGN AND MANAGEMENT OF ITS HIGHLY FRAGMENTED RETIREMENT INCOME SYSTEM.

Shyam: Government roles include:

- Educational to inform,
- Convening to get everyone to the table,
- Drafting boiler plate alternatives,
- Compulsion to minimize free riding, and ultimately,
- Risk pooling and safety net for the truly unfortunate


Larry:

It's the above. Self protection from free riding by our fellow man.

Keith:

RETIREMENT INCOME SYSTEMS SHOULD HAVE A MANDATORY PAY-GO FRONT-END (PILLAR1) THAT PROVIDES HIGH POST-WORK INCOME REPLACEMENT AT THE LOW INCOME END OF THE SPECTRUM. COMMON SENSE AND RESEARCH SUGGESTS THAT SUPPLEMENTARY PENSION INCOME FOR MIDDLE/HIGHER-INCOME WORKERS WORKS BEST WITH CLEAR TARGET BENEFITS, DYNAMICALLY-MANAGED DEFAULT OPTIONS, A CLEAR SPLIT BETWEEN RETURN-SEEKING AND PAYMENT-HEDGING INVESTMENT STRATEGIES, OPERATED BY NOT-FOR-PROFIT PENSION ORGANIZATIONS WITH GOOD GOVERNANCE AND GOOD SCALE ECONOMIES.

- Can a government effectively create a defined-benefit plan for government employees? What does that look like in terms of liability structure, asset management, and governance?

Larry: DB plans are used to run Ponzi schemes because the accounting is so opaque. Indeed, the only workable definition of a Ponzi scheme is a financial policy or instrument marked by opaque accounting.

Keith: US STATE AND LOCAL DB PLANS HAVE BECOME THE PONZI SCHEME POSTER CHILDREN OF THE WORLD. WHY? BECAUSE THERE IS NO EFFECTIVE REGULATORY PROCESS REQUIRING THEM TO BE TRANSPARENT, AND TO BE INTER-GENERATIONALLY FAIR.

Shyam: Defined benefit plans are guaranteed to induce poor incentives and are destined to fail. The only way to induce a sense of responsibility in society is to use defined contribution plans. It is not simply that their accounting is opaque; the problem is that their accounting cannot be anything but opaque. How do you value a DB plan in a world of changing interest rates and inflation?
www.thepurplesocialsecurityplan.org is a very simple structure for doing compulsory saving correctly. Take you 3 minutes to read. It's got personal accounts, social solidarity, compulsory saving, zero role for Wall Street, social insurance wrt annuitization, and is run by a single laptop. An Air is my preference. It has everyone earning the same return in the market subject to a government return guarantee. There is no reason for individual investment choice wrt to a basic saving system. People can exercise choice on their investments above the minimum required under this plan.

This Purple Social Security Plan is what Bismarck would advocate were he alive today and well trained.

Larry, I could only find arguments why there should be a purple social security plan, not a description of its mechanics.

Shyam: Index-based investment is free-riding on market information which is simply infeasible for funds of that size. Somebody has to make investment decisions which determine the price of securities, and those decisions are not cost free.

- Is there a call for a more concerted effort to “claw back” benefits from current public sector employees based on a “fraud upon the taxpayer” thesis (this might tie into Dr. Sunder’s discussion on accounting)? I’m not sure this is as relevant outside the US, so I’d appreciate input on that front.

Larry:

There has been fraud, but today's public sector employees and yesterday's (those who are retired) didn't perpetrate the fraud. Those who established the policies and underfunded the system are the true culprits. That said, we need to freeze the old plans in place and go with The Purple Social Security Plan for the entire country (and for any country). Employers are not our friends or our parents and should be entirely out of this business of forcing workers to save. They have made a complete mess and should never have been allowed to "protect" their workers.

Keith:

Gold-plated public sector plans are features of the US, UK, and Canadian landscapes. The USA is demonstrating that when loading financing problems off on the next generation is an option, that option will be exercised. The UK has run its public sector plans on a pay-go basis with fuzzy accounting, and is now suffering the budgetary consequences. Canada is in the least-critical situation as public sector pension plans have the same funding rules as private sector plans. However, processes are underway to limit future employer exposure only to contributions and not to pension guarantees.
Shyam:

Going forward, DB plans have to be replaced by DC plans. As for public sector plans, bankruptcy of the plans is an effective claw back; the only question is if the distribution of the claw backs more fair if we do not wait until the date of bankruptcy.

Keith

INTERESTINGLY, CONTINENTAL EUROPE TENDS NOT TO DIFFERENTIATE MUCH BETWEEN PRIVATE AND PUBLIC SECTOR PENSION BENEFITS. THE DIFFERENCE IS THAT, GENERALLY SPEAKING, THE NORTHERN EUROPEAN PENSION SYSTEMS ARE SUSTAINABLE, WHILE THE SOUTHERN ONE ARE NOT.

• What role do private sector employers have in retirement planning?

KEITH

None. WELL, NOT QUITE. I AGREE EMPLOYERS ARE THE WRONG PEOPLE TO MANAGE PENSION ARRANGEMENTS. THEY DO HAVE A ROLE IN ENSURING THAT THE DESIGN OF ANY SUPPLEMENTARY PENSION ARRANGEMENTS THEY ARE INVOLVED IN FUNDING (DIRECTLY OR INDIRECTLY) MAKES SENSE FROM BOTH THEIR AND THEIR EMPLOYEES' PERSPECTIVES.

(Those with more knowledge internationally than I can chime in, but my impression is that the Australian super funds and Canadian Pension Plan are in essence employer-agnostic – the requirement to pay into the system is based purely on income and not on employer.)

• This should get the ball rolling. Please let me know (1) potential availability for a call this Thursday or next Monday; (2) whether you will be at the Hyatt on Tuesday for an in-face meet-and-greet; and (3) if you have any additional topics/comments/questions to add to the discussion.

Larry

One final point on accounting. Economics is very clear on what's proper when it comes to accounting. There is only one way to properly account for the finances of a pension system, namely by calculating its infinite horizon fiscal gap using a proper risk-adjusted discount rate and actuarial assumptions. Table IVB6 in our the Social Security Trustees Report does this right for the U.S. Social Security system. It shows a $21 trillion hole in our Social Security system, which translates into it being 31 percent underfinanced. Both the Prez and the Gov say all Social Security needs to be is "tweaked." They are either clueless or lying as this table shows.
I am not sure what the economically correct accounting of DB pension plans is in a world of changing costs, inflation and interest rates. Economic growth, employment, wages, longevity

KEITH

LARRY, I HAVE TROUBLE UNDERSTANDING THE CONCEPT OF PAY-GO SYSTEMS BEING ‘UNDERFUNDED’. BY DESIGN, THERE IS NO INTENT TO PRE-FUND (EXCEPT MAYBE A LIQUIDITY BUFFER). I DO UNDERSTAND THE CONCEPT OF A CONTRIBUTION RATE THAT IS TOO LOW TO FINANCE PENSIONS IN PAY.

Thanks—

--Craig

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From: David Stewart [mailto:david@global-arc.net]
Sent: Friday, October 05, 2012 12:31 PM
To: kotlikoff@gmail.com; Craig Dandurand; Dandurand, Craig; Keith Ambachtsheer; shyam.sunder@yale.edu; lindat.roseborough@state.nm.us; Jerry.MoIarty@iapf.ie
Cc: samantha@global-arc.net
Subject: Wednesday 17th October panel

Dear Jerry, Larry, Keith, Shyam and Linda

Thank you again for agreeing to speak at Global ARC Boston.
I would like to take this opportunity to introduce you to Craig Dandurand of CalPERS who will chair your Wednesday 17th October panel.

Please find details below:

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